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GASB 34: What Does It Mean for the Rating Process?

Summary

Municipal debt issuers who are grappling with implementation of GASB 34 – one of the most sweeping changes to be required by the Governmental Accounting Standards Board – have frequently asked Moody's three questions:

1. What will happen to my rating at the time we first implement GASB 34?
2. What will happen to my rating if we do not implement GASB 34?
3. How will the new financial statements be incorporated into the rating process?

While this publication will answer those questions in depth, the short answer to them all is that GASB 34 will not change Moody's approach to credit analysis. It will change the financial statement's format, adding new and clearer information, and as a result it will raise new questions in our analysis. But the factors we consider when analyzing credit – the fundamentals of our analysis – will not change. As a result, we do not anticipate rating changes as a direct result from GASB 34.

Background: What Is GASB 34?

In June 1999, the Governmental Accounting Standards Board (GASB) issued Statement No. 34 ("*Basic Financial Statements and Management's Discussion and Analysis – for State and Local Governments*"), which mandated sweeping changes in the presentation and contents of government financial statements. In addition to its broad changes, Statement 34 has a far-reaching impact – it applies to all state and local governments (including school districts), public colleges and universities, public hospitals and healthcare organizations, public museums and cultural institutions, libraries, public utilities, and public employee retirement systems.

Statement 34 also requires presentation of more than one measurement focus. Government-wide financial statements will be prepared using the economic resources measurement focus and the accrual basis of accounting. At the same time, the separate major fund financial statements shall retain their existing measurement focus and basis of accounting. Governmental funds should maintain the current financial resource measurement focus and use modified accrual accounting. Proprietary and fiduciary funds should use the economic resources measurement focus and accrual accounting. GASB officials state that the two accounting approaches – together with requiring both government-wide financial statements and fund financial statements – result in a complete picture. "The relative strengths of the government-wide statement information are its *comprehensiveness* and *comparability.* The benefits of the fund statement information are its ability to inform questions of *budgetary* and *legal compliance*, to allow tracking of *dedicated resources*, and to provide *useful details* behind the government-wide statement," writes Dean Michael Ward in the GASB-published handbook, "An Analyst's Guide to Government Financial Statements."

Question No. 1 – Immediate Impact On Ratings?

In short, Moody's expects little or no rating impact from implementation of GASB 34. While the new requirements will alter the information we are given, it will not change the substance of our analysis or business approach. That is not to say that GASB 34 will have no impact. In fact, GASB 34 is a watershed event in governmental accounting and it will provide Moody's analysts with clearer, more detailed information. For example, the new MD&A section will discuss current-year results and compare them to prior-year results, most likely shedding light on areas that analysts will pursue further during in-person meetings or conference calls with officials. The new statements and notes will also give credit analysts a clearer bottom-line evaluation of overall government operations and improved trend analyses.

Moody's firmly believes that high-quality disclosure allows us to do a better job in the rating process and benefits the market as a whole. For that reason, we welcome the improved transparency of information that will result from the new statements. We do not, however, expect the changes to alter our analytical approach.

When Does GASB 34 Take Effect?

• Phase One - Governments with revenues of $100 million or more	FY ending after June 15, 2002
• Phase Two - Governments with revenues between $10-$100M	FY ending after June 15, 2003
• Phase Three – Governments with revenues below $10M	FY ending after June 15, 2004

Question No. 2 – Impact If We Do Not Make Changes?

Moody's is not the regulatory body behind GASB and, as such, we are not demanding compliance with GASB 34. It's not a make-or-break issue for us, particularly in the first years of implementation. In fact, Moody's has for years rated many municipalities that do not conform to GAAP requirements, such as New Jersey and many localities in the Midwest that use cash basis accounting. We also rate entities that have qualified opinions in their audit reports – most dealing with the reporting of fixed assets.

Interestingly, even GASB has no enforcement power to mandate compliance with Statement 34. The closest thing to enforcement is that all auditors (through the AICPA's Rules of Conduct) must report any divergence from GASB standards, and of course Statement 34 is now included in GASB's standards. GASB officials expect – and Moody's agrees – that the market will come to expect compliance with GASB 34, with interest rate pricing eventually reflecting the perceived lack of disclosure from entities that do not implement GASB 34.

Accounting presentation is but one of many factors that Moody's examines. We will continue to focus our analysis on areas within our five major credit factors: security, debt, economy/demographics, finances and management. If an issuer of fixed-income debt does not comply with GASB 34, Moody's analysts will be interested in the reasons behind that outcome. The non-compliance could be evidence of weak management – in which case it does relate to a credit factor that we will pursue further. On the other hand, it could be the result of a cost-benefit decision by the issuer – in which case we are less likely to consider the non-compliance an indication of credit-related concerns. In sum, Moody's is not demanding compliance, nor are we recommending that any issuers not comply. Our overall interest in audited documents remains transparency and an accurate representation of the issuer's financial picture.

Question No. 3 – How Will This Be Used In The Rating Process?

Moody's existing analytical approach will be aided by the additional information provided in issuers' financial statements, as prepared in accordance with GASB 34. Many of our existing analytical areas will have greater detail as a result of the new standards.

Specifically, Moody's expects the new information and/or presentation to be used in the analytical process in the following ways:

- **Management Discussion and Analysis** – The MD&A section will give us valuable standardized background information that will help round out our knowledge of the entity's historical operating performance and financial position. As in the SEC's required disclosures, the insights garnered will most likely vary considerably, but those issuers that go beyond boiler-plate language and "elevator analysis" (this went up, that went down) will be meeting the spirit of this new section.
- **The Government-Wide Statement of Net Assets** – Although this section has caused perhaps more angst among government officials than any other part of GASB 34, it will ideally give credit analysts a clearer picture of the actual level of historic and ongoing investment in infrastructure. (It should be noted that it will take longer for trend data on infrastructure assets to materialize, as governments have an additional four years after GASB 34's implementation to publish retroactive information on infrastructure assets.) Furthermore, use of the

modified approach may provide additional information on management's assessment of their infrastructure's condition. However, Moody's also realizes that questions will arise about the quality of the information, as methodologies will vary, and therefore we expect that this information will not be comparable across issuers. Our analysts will consider all of this – the new information about fixed assets, the methodology used by that particular entity and potential questions of data integrity – when weighing this information in our analysis. And as before, our particular focus will remain with the issuer's capital plan.

- **Classification of Assets and Liabilities –** Governments are encouraged, but not required, to list assets and liabilities in descending order of liquidity or to present a classified Statement of Net Assets. This will assist analysts in determining issuers' true liquidity.
- **Unrestricted (deficit) Net Assets –** In certain circumstances, governments that have recorded a positive fund balance in the individual fund balance sheet will also present a deficit balance in unrestricted net assets at the government-wide level. This condition arises when total net assets are less than restricted net assets. This unexpected result can arise from the net impact of presenting a smaller amount of non-current assets, such as fixed assets and infrastructure, than of non-current liabilities, such as debt. Moody's will continue to focus our analysis on fund balance at the individual major fund level. (Please see Moody's publication "Your General Fund Balance – One Size Does Not Fit All!" published in February 2002.) However, if a deficit net assets is recorded, we would want to obtain an understanding of how this arose. As trend analysis becomes available, changes in unrestricted net assets may generate further interest.

Other Moody's Publications on GASB 34

On this general topic, Moody's has also published "Public Universities' Move to New Accounting Standards Under GASB 35 Will Not Affect Credit Quality" in September 2001 and "Moody's Rolls Out Finetuned Ratios for Public Universities to Incorporate New GASB Standards" in June 2002.

- **Government-Wide Statement of Activities** – Seeing which governmental programs generate sufficient revenue to "self-support" will give us more information on possible budgetary pressures, such as, for example, declining state aid for social service programs. We may also look at how the degree of actual self-sufficiency varies from management's stated intentions or policy goals. Moody's will not, however, consider whether the government ought to achieve self-support on non-enterprise system government services, as that is a political question, not a credit concern.
- **Depreciation Expense –** The Statement of Activities will include depreciation expense, with the calculation based on the estimated useful life of each asset. Moody's practice when analyzing enterprise systems is to exclude depreciation from operating expenses; we will continue to do so for all governmental statements.
- **Elimination of Interfund Activity –** We believe that the elimination of the interfund activities, which were reported "grossed up" in the prior model, will provide a clearer representation of the magnitude of actual financial activity.
- **Governmental Funds Statement of Revenues & Expenditures** – By requiring a break-out of the various types of locally-derived tax revenues and special/extraordinary items, the new statements will give greater detail to analysts.
- **Major Funds Presentation -**The actual funds that are detailed will change for most entities. The identified funds will be broken down into "Major Funds," which is defined as the main operating fund and any individual government or enterprise fund with assets, liabilities, revenues or expenses that are 10% of the total for all governmental or enterprise fund, or 5% for all governmental and enterprise funds combined. The result is that, instead of City A publishing the traditional combined General Fund, Special Revenue Fund, Capital Projects Fund and Debt Service Funds, it might publish, for example, a General Fund, Route 7 Construction Fund, Community Redevelopment Fund, and so on, with the minor funds aggregated into "Other Governmental Funds." This change will present an obstacle to analysts comparing year-to-year numbers during the first few years of GASB 34-compliant audits, and it may pose minor challenges to our tracking of debt service expenditures. But Moody's believes that this difficulty will be short-lived, as complete trend analysis will be available once a few years of GASB 34 audits are published. Also, any information that was historically available, and continues to be relevant to the rating process, can be provided as a supplement.
- **Proprietary Funds Statement of Cash Flows** – The direct method is now required, and Moody's believes that although it is more difficult to prepare, it does provide a superior level of information for analysis.
- **Budgetary Comparison Reporting –** The inclusion of originally budgeted numbers, with amended budget and actual results, will provide us with greater insight into the changes that occurred through the year and may reflect on management and perhaps the economy. In addition, significant variances may be articulated in the MD&A section.

Summary

It should be noted that the issue related to materiality of funds (discussed above in "Major Funds Presentation") came to light during Moody's review of some of the financial statements of GASB 34 "early adopters." Our commitment to buy-side analysis will result in our publications of Special Comments such as this in order to keep market participants aware of these insights and our opinion relevant developments.

Overall, Moody's believes we are at the very beginning of a several-year transition period in which governmental issuers fine-tune their financial statements to be GASB 34-compliant. The market is continuing to become increasingly expectant of compliance, and credit analysts must learn how to analyze the new financial statements thoroughly. All of the parties – governments, accountants, analysts and others – will have to work through the changes together. Moody's intends to avoid surprising any issuers of debt with our approach to this monumental change. We do expect a good faith effort at disclosure, no matter the accounting presentation. We do expect the new disclosure to raise additional questions for our analysis; but we do not expect any rating changes as a direct result of GASB Statement 34.

Components of a GASB-34 Compliant Financial Report

Basic Financial Statements

Government-Wide Financial Statements

- Governmental Activities
- Business-Type Activities
- Component Units

Fund Financial Statements

- Governmental Fund
- Proprietary Fund
- Fiduciary Fund

Notes to the Financial Statements

Required Supplementary Information (RSI)

MD&A is the report's first section; all other RSI follow the financial statements and notes

- Management's Discussion and Analysis (MD&A)
- Budgetary comparison
- Pension information
- Modified approach infrastructure information
- Public entity risk pool information

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